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INTERNATIONAL ECONOMIC SITUATION: Japan and Canada were the only major countries to keep their foreign exchange markets open yesterday.

In Tokyo, the government has refused to permit the dollar to float. On 16 and 17 August, the central bank acquired about $1.3 billion from Japanese foreign exchange banks and Japanese exporters in order to maintain parity, bringing total Japanese foreign exchange reserves to about $10 billion. Tokyo reportedly believes that these types of transactions could result in purchases by the central bank this month of an additional $2 to $3 billion. Tokyo's exchange controls, however, make a capital inflow of comparable magnitude by foreign speculators virtually impossible.

Tokyo is reluctant to permit the dollar to depreciate because it would hurt Japanese exports to the US at a time when the Japanese economy is sluggish. The government is already concerned that the ten-percent surcharge on US imports will make it more difficult to get the Japanese economy moving. [redacted] 25X1

The Japanese probably hope to keep their exchange market open and maintain the existing dollar rate at least until some multilateral revision of the monetary system and exchange rates can be agreed upon. Tokyo probably realizes, however, that the present rate is not likely to be maintained much beyond the time that European exchange markets are reopened. Any depreciation of the dollar relative to European currencies and maintenance of the present yen-dollar rate would result in de facto devaluation of the yen vis-a-vis the European currencies, bringing a storm of protest from Europe.

(continued)

Canada believes that the rise in its currency against the dollar in the last two days to a high of 99.3 cents by itself significantly affects its trade. It plans to send a delegation to Washington later this week to seek exemption for Canada from the ten-percent levy on imports. About two thirds of Canada's total exports went to the US last year; thus, the Canadians, already suffering from an unemployment rate of over six percent, feel they will be particularly hard-hit by the US moves. Canada claims that about one fourth of its exports to the US will be adversely affected by the surcharge.

The EC monetary committee met yesterday in Brussels to discuss a common course for the six member countries and to prepare for an EC Council session tomorrow. Press accounts state the monetary committee decided the likeliest solution for the Community in the crisis is a joint upward float of the EC's currencies against the dollar. But accounts of a subsequent meeting of the EC Commission indicate that this body was having difficulty in framing concrete proposals on which the Council could act. In any case, the position of France, the principal opponent of a joint float proposal by Bonn last May, probably will be determined at the special cabinet meeting scheduled for this afternoon by President Pompidou. Under the present circumstances, Paris will be under greater pressure to participate in a coordinated EC response.

The UK hopes to coordinate its policy with that of the EC. Whatever decision is adopted by the EC will inevitably influence the policies of other European nations, notably Switzerland. Until these European policy-making processes are completed, most of the major foreign exchange markets probably will remain closed. A premature opening of the markets could precipitate a large, undesired run from the dollar, partly in reaction to the news that the US second quarter balance-of-payments deficit was the worst in history. [redacted] 25X1

<u>BRAZIL-NETHERLANDS</u>: Brazil is concluding its second agreement to permit foreign boats to fish within its claimed territorial waters.

On 19 August the Brazilian and Dutch governments are scheduled to sign notes putting into effect an agreement that will authorize Surinamese-owned boats to fish for shrimp within the 200-mile zone claimed by Brazil since 1970. Like the agreement signed with Trinidad and Tobago on 4 August, this accord commits the Surinamese to pay registration and operation fees as well as an "economic compensation" charge in return for the right to fish during this current season, which ends on 31 October. In both cases, the agreements cover only a very small percentage of the fishing boats actually operating out of their ports, because most of the boats are owned by foreign--mainly US--firms.

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ARAB STATES: The three heads of state are meeting in Damascus today to approve the Federation of Arab Republics draft constitution and to discuss the uncertain situation along the Jordan-Syria border.

The Egyptian, Syrian, and Libyan leaders are expected to endorse the text of the new constitution, which will be submitted to a plebiscite in each country on 1 September. The Libyans and Syrians have conducted "educational campaigns" to drum up popular enthusiasm for this latest venture toward greater Arab unity.

The conclave will no doubt take up the more pressing problem of the altercation between Damascus and Amman. The three are also likely to continue discussions begun at the Arab summit meeting in Tripoli on 30 July aimed at devising a formula for an agreement between King Husayn and the fedayeen. The sessions are apt to be turbulent, in view of the known wide differences on various important issues between Qadhafi, who is pressing for sanctions against Jordan, and Sadat, who is committed to the current mediation efforts of an Egyptian - Saudi Arabian mission. 25X1

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<u>BELGIUM</u>: The government, although satisfied with the first six months' experience with the value-added tax (VAT), is concerned about possible inflationary effects and shortfalls in tax revenues.

Aided by governmentally administered price controls, the Belgian Government was able to hold the rise in consumer prices to a moderate 2.7 percent during the first six months following a shift to the VAT in January to conform with the tax harmonization within the European Communities. It appears likely that the government's goal of limiting the increase in consumer prices to 6.5 percent for the entire year will be attained. If price controls were lifted, however, the consumer price index would rise significantly because the government has refrained from granting price increases to those products represented in this index.

Revenue from the VAT has been close to that forecast by the government, but potentially serious shortfalls in budget revenue may develop next year. Temporary taxes on capital equipment, inventories, and exports, which will be reduced or will expire at the end of the year, will result in loss of revenues roughly equivalent to two months of VAT revenues. To avoid a deficit, the Belgian Government could raise the VAT rates, but the increase in prices that would follow could imperil the government's chances in the national elections scheduled to be held no later than next spring. [redacted] 25X1

CAMBODIA: The recent easing of economic pressures in Phnom Penh is almost certainly temporary.

Despite a high level of rice deliveries since early July, official stock figures indicate rice reserves in the capital have declined substantially. The government has yet to take steps necessary to discourage hoarding, and its ability to obtain rice on concessional terms from Taiwan or Japan is uncertain. Although it still is too early to make firm predictions about next year's harvest, planting reportedly is lagging with only a month or so left in the planting season.

The economy faces the prospect of further inflation even though the price of best-grade rice has recently declined and prices of other commodities have been relatively stable. Foreign exchange reserves are at a near crisis level. The government nevertheless has postponed action on the potentially unpopular reform measures proposed by the International Monetary Fund (IMF), which will probably have a negative impact on the willingness of prospective donors to participate in the Exchange Support Fund, an arrangement now under consideration to help stabilize the economy. [redacted] 25X1

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COMMUNIST CHINA - IRAN: Iran has established diplomatic relations with Communist China. Tehran's recognition of the Peking regime as "the sole legal government of China" is the same formula used by several other governments over the last year to establish diplomatic ties with Peking. In agreeing to this broad formulation, Iran evidently made no promises to the Chinese concerning Peking's bid for UN membership, but at least will vote for Peking's admission. [redacted]

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